APPENDIX B

Testimony of Merton J. Peck, Professor of Economics, Yale University, in I.C.C. Finance Docket 21989, December 9, 1966, Exhibits FH-42 (qualifications) and FH-43.

My name is Merton J. Peck, and I reside in New Haven, Connecticut. By profession I am an economist, and I am currently a Professor of Economics at Yale University.

I received my Bachelor of Arts degree from Oberlin College in 1949 with a major in economics. I then began graduate work in economics at Harvard University. In 1951 I received a Master of Arts degree and in 1954 a Doctor of Philosophy degree, both from Harvard. My special field in graduate school was market organization which deals with competition, antitrust policy, and government regulation.

In the early 1950's, while studying for my Doctor's degree, I held various teaching positions at Harvard. In 1955 and 1956 I was an Assistant Professor of Economics at the University of Michigan. In 1956 I left Michigan to become an Assistant Professor of Business Administration at Harvard University, and I remained there until 1961, becoming an Associate Professor in 1960. In 1961 and 1962 I served as Director of Systems Analysis in the Office of the Assistant Secretary of Defense (Comptroller). In the spring of 1963 I was a member of the Senior Staff of the Brookings Institution, working on problems of transportation policy and technological change. In July of 1963 I was appointed to my present position as Professor of Economics at Yale University.

My teaching has been largely in courses dealing with the economics of competition and monopoly and the economics of regulated industries. Most of my writing has been in that field, and a fair portion has dealt with the transporta-

tion industries. These include joint authorship of *Economics of Competition in the Transportation Industries* (Harvard University Press, 1959) and a forthcoming book on technological change and economic growth. In addition to work on these and other books, I have contributed to professional journals and to such works as *Perspectives on Antitrust Policy* (Princeton University Press, 1964) and *Transportation Economics* (Columbia University Press, 1965).

My statement is concerned with some of the anticompetitive consequences of indemnity plans and protective conditions of the general type prescribed in Appendix G of the Commission's Penn-Central decision of April 6, 1966,[1]—namely, provisions for (1) restrictions on competition of the merged road with the protected roads, and (2) indemnity payments based on revenue shares. The protective conditions and indemnity plan were to benefit the Erie-Lackawanna, Delaware and Hudson, and Boston and Maine and thus offset in some unknown degree the consequences of the merger upon these three railroads.

My statement is organized around three points: (1) market sharing and revenue sharing systems have anticompetitive consequences; (2) traffic conditions of the type prescribed by the Commission are, in economic terms, market sharing systems, and (3) the indemnity plan under the arrangements set forth in the Commission's Penn-Central decision is, in economic terms, a revenue sharing system.

My statement is not based on an empirical investigation of competition between, on the one hand, the Erie-Lackawanna, Delaware and Hudson, and the Boston and Maine with the Penn-Central, on the other. Rather, it is based on

[1] Pennsylvania Railroad Company—Merger—New York Central Railroad Company, 327 ICC p. 475 at 532.

the assumptions which are set forth below, together with the facts bearing on the reasonableness of these assumptions.

I. MARKET SHARING AND REVENUE-SHARING SYSTEMS HAVE ANTI-COMPETITIVE CONSEQUENCES.

Market sharing systems are defined as devices (usually by agreement) whereby rival firms do not compete for certain customers served by their rivals, and in this way the market is shared. The customers involved lose the benefits of rivalry for their patronage. Since each firm has certain customers protected from the competition of its rivals, there is less necessity for a firm to engage in price reductions and quality improvements to maintain its sales. Similarly, since each rival has protected customers, any one firm will have less incentive to engage in price reductions and quality improvements to expand its sales. For these reasons, market sharing systems are considered by economists as anti-competitive.

I consider all market sharing systems as anti-competitive although some are effective and some are not. I would apply the same economic logic that Carl Kaysen and Donald F. Turner apply to price agreements, namely, "Whenever such agreements are effective, they limit competition in an undesirable way. When they are ineffective—which they frequently are because they do not embrace a large enough share of the market or they are not backed up by a sufficiently powerful enforcement mechanism, or they do not provide for effective control over entry—they do no positive good."[1]

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[1] Carl Kaysen and Donald F. Turner, *Antitrust Policy: An Economic and Legal Analysis* (Cambridge, Massachusetts, 1959), p. 154.

Revenue sharing systems are defined as devices (usually by agreements) assigning each firm a share of the total revenue realized by the firms in the revenue sharing system. Since each participant is guaranteed a share of the total revenue, such a system discourages the participants from competing with one another and instead motivates the participants to expand the total revenues to be pooled. Economists consider such systems to be anti-competitive. Again, the degree of the anti-competitive effect of a revenue sharing system depends on the shares of the market involved.

II. THE PROTECTIVE CONDITIONS IN THE COMMISSION'S APRIL 6, 1966 PENN-CENTRAL DECISION ARE IN EFFECT MARKET SHARING SYSTEMS.

The Commission summarized its protective conditions as designed to accomplish "the temporary preservation of present practices and patterns (as to broad routes of movement and volume) on traffic for which the Erie-Lackawanna, Delaware and Hudson, and Boston and Maine compete with applicants and other railroads making up the proposed system."[1] To the extent that this statement means that Penn-Central cannot take any competitive actions which would divert or tend to divert business from Erie-Lackawanna, Delaware and Hudson, and Boston and Maine, it creates a market sharing system. It contains the essential element of a market sharing system in that a competitor does not seek out the patronage of customers of its rivals. It is not a full-scale market sharing system in that the Erie-Lackawanna, Delaware and Hudson, and Boston and Maine are not prohibited from taking competitive actions against Penn-Central. On the other hand, their incentive

[1] 327 ICC p. 475 at 532.

for such actions is reduced by the revenue sharing system described below.

The market sharing character of the protective conditions is further demonstrated by their specific effects on three significant ways of competing: price reductions, service improvements, and traffic solicitation. With respect to price reductions and service improvements, the Commission's April 6th opinion states: "Pending final determination of the petitions for inclusion filed by the Erie-Lackawanna, Delaware and Hudson, and Boston and Maine in this proceeding and in Finance Docket No. 21510 et al, or such other period of time as the Commission may prescribe, hereinafter called the protective period, and on traffic for which the Erie-Lackawanna, Delaware and Hudson, and Boston and Maine are competitive factors, the merged company shall not publish or provide for any new or changed routing practice and/or freight rates of services, either locally or jointly with other carriers, which would divert or tend to divert traffic from routes in which the Erie-Lackawanna, Delaware and Hudson, and Boston and Maine now participate, or participated in at the time this merger application was filed or take any action or engage in any practice or conduct contrary to the purposes and general objectives of this report."[1] I assume this provision precludes the Penn-Central from changing rates or service in order to obtain business from its competitors.

With respect to traffic solicitation, I am informed that Penn-Central has taken the position that the protective conditions would preclude any solicitation by Penn-Central of shippers now using competitive routes of the Erie-Lackawanna, Delaware and Hudson, and Boston and Maine which might lead these shippers to shift their traffic to Penn-Central routes.

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[1] 327 ICC, 475 at 561.

With the Penn-Central precluded from (1) rate reductions, (2) service improvements, and (3) traffic solicitation that would divert or tend to divert business from the three railroads—the Erie-Lackawanna, Delaware and Hudson, and Boston and Maine—the result is that Penn-Central cannot compete for their customers. Hence these railroads have a market share protected from a competitor. It is then a market sharing system. As indicated above, market sharing systems are anti-competitive.

There remains the question as to whether the protective conditions are an effective market sharing system. In the Kaysen-Turner quotation, price fixing agreements were considered ineffective when (1) they did not embrace a sufficient share of the market, (2) they were not backed up by a sufficiently powerful enforcement mechanism, or (3) they failed to control entry. The same conditions limit the effectiveness of market sharing systems.

As to the last two factors, I note that the Commission sets forth in its opinion a mechanism for enforcement and the possibility of the entry of new railroads by construction is unrealistic.

As to the share of the market involved, I am informed that the Erie-Lackawanna, Delaware and Hudson, and Boston and Maine provide the only remaining railroad competition of any consequence for the Penn-Central throughout most of New England and large parts of New York State. In view of the obvious economic importance of this area, the elimination of competition here cannot be regarded as *de minimis*.

I recognize that the protective conditions are intended to be only temporary expedients. I do not have any idea how long they would be maintained here if they became effective. However, they would have these anti-competitive effects for their duration, and the longer they remained, the worse these effects would be.

III. THE INDEMNITY PLAN, IN ECONOMIC TERMS, CREATES THREE REVENUE SHARING SYSTEMS.

The indemnity plan, as originally prescribed by the Commission, assigns each of the three railroads a share in the total of the sum of their respective revenues and that of the Transportation Company as follows: for the Erie-Lackawanna, 13.0967 percent; for the Delaware and Hudson, 3.2819 percent; and for the Boston and Maine, 4.2578 percent. I understand that the three protected lines are seeking to increase these shares, but whatever shares are fixed, the principle is the same. If any one of these railroads realizes less than its share, then the Transportation Company pays an indemnity.

The indemnity plan originally prescribed may or may not be fully equivalent to the value of the volume of traffic under the assigned share. I understand that the three protected lines are seeking increases in their indemnity factors. I have not studied what formula would provide full compensation for the loss of traffic, and it is not the purpose of this statement to go into that question.

The market affected is the same for revenue sharing conditions as for the market sharing conditions previously discussed, as are the enforcement and entry conditions. The temporary nature of the arrangement is also the same.

The indemnity plan has the essential features of revenue sharing systems. The participants in each of the three revenue sharing systems involved have an interest in expanding the total revenue of those in that system at the expense of non-participants. The participants in each of the revenue sharing systems also have less incentive to expand their own sales at the expense of the other party in their revenue sharing system.